In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 633

CROSBY VALVE & GAGE COMPANY (FORMERLY CROSBY STEAM GAGE & VALVE CO.), PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question in this case is whether a business corporation, wholly owned by a charitable foundation, may claim charitable deductions under Section 170 of the Internal Revenue Code of 1954 for its equity interest in bonds given to its parent, or whether the amount must be treated as nondeductible dividends under Section 316 of the Code.

Petitioner is a manufacturing corporation all of whose stock is owned by Stone Charitable Foundation, an organization exempted from taxes by Section 501(a), (c)(3) (R. 40–41).[1] During each of its three

[1] "R." references are to the record appendix to petitioner's brief in the First Circuit.

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taxable years ending October 31, 1954, 1955, and 1956, petitioner turned certain bonds over to the foundation. It claimed a charitable deduction for its equity in the bonds (R. 37, 41–44). The Commissioner disallowed the deduction and asserted deficiencies on the ground that the distribution amounted to a dividend paid to petitioner's sole shareholder.

The Tax Court, in a reviewed decision, upheld the Commissioner's determination on two alternative grounds: (1) the transfers were not charitable contributions within the meaning of the Code Section 170 (c), since they did not proceed from a detached and disinterested generosity (R. 46–50); and (2) denial of the deduction was required by the legislative purpose and provisions of Code Sections 502 and 511–514, relating to the taxation of business income of exempt organizations and their "feeders", such as petitioner admits it is (R. 51–55).[2] The court of appeals rejected the first ground, but affirmed on the second (Pet. 18–22).

The result below is correct. It is not in conflict—or alleged to be in conflict—with any other decision. No ground for further review exists.

1. Petitioner is wrong in arguing (Pet. 5–6) that the court below has interfered with or subverted the congressional policy of encouraging private philanthropy through the charitable deduction. Petitioner's distributions to its sole shareholder could equally fall within the wording of either Section 170(c)(2)(B)

[2] The majority of the Tax Court relied primarily upon the first ground, while the concurring judges relied solely on the second.

which defines charitable contributions[3] or Section 316(a), which defines a dividend as "any distribution of property made by a corporation to its shareholders" to the extent of the corporate earnings. Faced with no clear statutory directive, the court below properly looked to the legislative purpose of the Revenue Act of 1950[4] which imposed tax on the "unrelated business income" of charities.

By this Act Congress sought to eliminate the unfair advantage that a business operated by a charity theretofore had in competing with similar businesses that could not claim tax-exempt status. As the House Committee stated (H. Rep. No. 2319, 81st Cong., 2d Sess., p. 36):

> The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of these section 101 [1954 Code, Section 501] organizations enables them to use their profits tax-free to expand operations, while their com-

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[3] Section 170(c) provides, in pertinent part:

Charitable Contribution Defined.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

* * * * *

(2) A corporation, trust, or community chest, fund, or foundation—

* * * * *

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

* * * * *

[4] Revenue Act of 1950, c. 994, 64 Stat. 906; see H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 36–41 (1959–2 Cum. Bull. 380, 408–412); S. Rep. 2375, 81st Cong., 2d Sess., pp. 28–33 (1950–2 Cum. Bull. 483, 504–508).

petitors can expand only with the profits remaining after taxes. * * *[5]

To make taxes a neutral factor in the competitive strength of businesses operated by charities Congress enacted the predecessors of Section 502 and Sections 511–515 of the Internal Revenue Code of 1954. The latter provisions deal with businesses operated directly by tax exempt charities; Section 502 involves businesses operated indirectly through subsidiary, or "feeder," corporations such as petitioner.

Section 511(a)(1) imposes an income tax on the "unrelated business income" of an otherwise exempt charitable organization. Sections 512 and 513 define unrelated business income as income from "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption".

To make certain that tax-exempt status not attach to businesses carried on indirectly through corporate subsidiaries of charities, Congress provided in Section 502 that "feeder organizations" such as petitioner "shall not be exempt [from taxation] * * * on the ground that all of its profits are payable to one or more

[5] See also President's Message to 81st Congress (H. Doc. No. 451, 81st Cong., 2d Sess., p. 5); Supplementary Treasury Department Statement on Tax Exempt Organizations (1 House Hearings before the Committee on Ways and Means, Revenue Bill of 1950, 81st Cong., pp. 165–166); *United States* v. *Community Services*, 189 F. 2d 421 (C.A. 4), certiorari denied, 342 U.S. 932.

organizations exempt * * * from taxation." See H. Rep. No. 2319, *supra,* at p. 37; S. Rep. No. 2375, *supra,* at p. 29.

Petitioner's essential contention is that it, like any corporation, may make deductible gifts to charities. Certainly, in computing its unrelated taxable business income, a charitable corporation—or its subsidiary—may, like any other corporation, deduct up to 5 percent of its unrelated business taxable income for contributions and gifts to organized charities. Section 512 (b) (1) and (10). But a subsidiary of a charity may claim a deduction only for gifts to charities other than its parent—just as a charity that operates a business directly could not claim a deduction for a "gift" to itself of 5 percent of its "unrelated business income." This position, expressly taken in the applicable Regulation, see Treas. Regs. 1.512(b)–1(g)(3), 26 C.F.R., is founded upon a clear indication of Congressional intent revealed in the Committee Reports accompanying the 1950 legislation (H. Rep. No. 2319, 81st Cong., 2d Sess., p. 111; S. Rep. No. 2375, 81st Cong., 2d Sess., p. 109):

> The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a section 101(6) [1954 Code, Section 501(c)(3)] incorporated educational institution operating an unrelated business would be allowed a deduction up to 5 percent of its unrelated business net income for amounts of income from any source paid over to the Red Cross but would not be allowed any deduction for amounts of business income which are used to defray its own expenses in administering its own educational program.

To preserve the purpose of Section 502—that "feeder" corporations whose profits are paid over to charities should be taxed on the same basis as businesses that charities operate directly, or that have no connection to tax-exempt organizations—all the feeder's payments of earnings to its parent must be treated as dividends rather than charitable contributions.[6] Otherwise such a feeder could divert 5 percent of its earnings to its owner free of tax, and thereby gain a tax advantage over a competitor operated directly by a charity, or whose owners have no tax exemption.[7]

Thus, contrary to petitioner's contentions (Pet. 6–8), the purpose of the unrelated business income provisions of the Code requires that the charitable contribution deduction should be allowed only for gifts to charities other than the feeder's stockholder, and payments to the parent must be considered as dividend distributions of business profits. In the words of the court below (Pet. 22), "petitioner can take full advantage of the deduction by contributing to any *other* charity. Its universe is decreased by only one member."

2. The First Circuit did not, as petitioner claims (Pet. 8–9), ignore the rule that a subsidiary corporation and its parent-stockholder are separate tax entities.[8] That petitioner and its parent are separate

[6] See H. Rep. No. 2319, *supra*, p. 37; S. Rep. 2375, *supra*, p. 29.

[7] See the example in footnote 3 of the opinion below (Pet. 21).

[8] *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C.A. 2), the authority petitioner cites in support of this argument, involved an issue—interest deduction—far removed from that presented here. Petitioner does not, and cannot, assert a conflict with *Kraft*.

entities is indeed essential to the holding that the former's payment to the latter constituted a dividend.

3. There is no substance in the suggestion (Pet. 9–10) that an "injustice" would result from denial of the petition pending disposition of an appeal to the court below in another case, *Knapp Brothers Shoe Manufacturing Corp.* v. *United States,* 265 F. Supp. 133 (D. Mass.), on appeal, No. 6955, C.A. 1, that involves a related issue. Even if the court below were to decide that case in a manner inconsistent with its decision in this one, there would be no basis for review in this Court. See *Wisniewski* v. *United States,* 353 U.S. 901, 902.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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